Supreme Court, U.S.
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No.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1994

JOSEPH P. CAULFIELD,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Petition for a Writ of Certiorari to the United States Supreme Court
From the United States Court of Appeals for the Eighth Circuit

PETITION FOR WRIT OF CERTIORARI

JERRY L. SUDDARTH*
SUDDARTH & KOORS
755 West Terra Lane
O'Fallon, Missouri 63366
(314) 240-7644

Attorney for Petitioner

*Counsel of Record

St. Louis Law Printing, Inc. 13307 Manchester Rd. St. Louis, MO 63131 314-231-4477

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QUESTIONS PRESENTED

1. Whether the Eighth Circuit United States Court of Appeals has erred by rendering a decision in conflict with the decision of another United States Court of Appeals on the same matter?

2. Whether the Eighth Circuit United States Court of Appeals has decided an important question of Federal law, which has not been, but should be settled by this court?

3. Whether the Commissioner of Internal Revenue exceeded the authority granted by the United States Congress by arbitrarily assessing additional liability to a taxpayer for negligence penalties under I. R. C. §6653(a)(1) and 6653(a)(2), and additions to tax under I. R. C. §6661 by arbitrarily assessing additional liability to a taxpayer for understatement of income when taxpayer has demonstrated good faith?

4. Whether records, accepted by the Commissioner of the Internal Revenue as adequate in one year, can be deemed inadequate in other years, when records are kept in the same manner?

5. Whether the Commissioner of the Internal Revenue exceeded the authority granted by the United States Congress by arbitrarily reconstructing a taxpayer's income?

6. Whether the Commissioner's assessment was entitled to a presumption of correctness when it is demonstrated that there were substantial errors and nontaxable income was included?

7. Whether the Commissioner of Internal Revenue exceeded the authority granted by the United States Congress by arbitrarily designating bank loans as taxable income and whether a loan, however named or labeled, can be included as taxable income?

8. Must the Commissioner investigate sources of nontaxable income under *Holland v. United States*, 348 U. S. 121, 75 S. Ct. 127, 99 L. Ed. 2d 150 (1954)?

9. Did the Tax Court err? Must the Commissioner make prima facia showing of negligence, before the burden is placed on the taxpayer to disprove the negligence?

LIST OF PARTIES

The petitioner is Joseph P. Caulfield.

The respondent is the Commissioner of Internal Revenue.

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OPINIONS BELOW

The Memorandum Findings of Fact and Opinion of the United States Tax Court, filed September 14, 1993, is reprinted in Appendix A.

The opinion of the United States Court of Appeals, for the Eighth Circuit, filed August 29, 1994, is reprinted in Appendix B.

The October 19, 1994 denial of suggestion for rehearing en banc and petition for rehearing from the United States Court of Appeals for the Eighth Circuit is reprinted in Appendix C.

STATEMENT OF JURISDICTION

The jurisdiction of the Tax Court was proper pursuant to I. R. C. §6213 and I. R. C. §7442.

Appellate jurisdiction for the United States Eighth Circuit Court of Appeals is based on I. R. C. §7482(a). Entry of Judgment was made by the United States Court of Appeals on August 29, 1994. Appendix B. Appellant's Petition for Rehearing was denied by the United States Court of Appeals on October 19, 1994. Appendix C.

Jurisdiction of this Honorable Court is invoked pursuant to Supreme Court Rule 10, Paragraphs A and C.

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

1. Article 1, Section 8, paragraph 18 of the United States Constitution provides that: "The Congress shall have power . . . To make all Laws which shall be necessary and proper for carrying into Execution the foregoing Powers, and all other Powers vested by this Constitution in the Government of the United States, or in any Department or Officer thereof."

2. Amendment I of the United States Constitution provides that: "Congress shall make no law . . . prohibiting the free exercise . . . to petition the Government for a redress of grievances."

3. Amendment VIII of the United States Constitution provides that:: ". . . nor excessive fines imposed . . ."

STATEMENT OF THE CASE

This action challenges the constitutionality of the Commissioner of Internal Revenue's authority to arbitrarily reconstruct a taxpayer's income and the extent to which the Commissioner may err to lose the presumption of correctness that normally

attaches to an assessment pursuant to I. R. C. §6001 Treas. Reg. §6001-1(a); and asks this Court to clarify the conflict in the decisions rendered between the different circuits of the United States Court of Appeals.

The Eighth Circuit interpretation of the Commissioner of Internal Revenue's authority pursuant to I. R. C. §6001. Treas. Reg. §6001-1(a).

The Commissioner of Internal Revenue's arbitrary authority to designate "Bank Loans" as taxable income. The Commissioner of Internal Revenue's arbitrary authority to assess additional liability under I. R. C. §6653(a)(1) and 6653(a)(2), and substantial understatement of income under I. R. C. §6661, when the taxpayer has demonstrated a good faith effort.

The Eighth Circuit interpretation of the Commissioner of Internal Revenue authority pursuant to I. R. C. §6653(a)(1), 6653(a)(2), and I. R. C. §6661.

The Eighth Circuit interpretation as to the extent an issue must be raised to be preserved for an appeal.

Joseph P. Caulfield petitioned the Tax Court to redetermine the tax deficiency set forth in the notice of deficiency. The Tax Court sustained the deficiency against Mr. Caulfield. The Petitioner timely appealed to the Eighth Circuit Court of Appeals on September 12, 1994. The Eighth Circuit upheld the decision of the Tax Court. A Petition For Rehearing was filed, but denied by the Eighth Circuit on October 19, 1994.

The Petitioner, Joseph P. Caulfield, was engaged in the business of being a public insurance adjuster. Mr. Caulfield resided in Missouri and he pursued his business activity as a sole proprietor. For Federal income tax purposes, Mr. Caulfield reported income and deductions under the cash receipts and disbursements method of accounting. Mr. Caulfield filed his U.S. individual Income Tax Return, Form 1040, for the taxable

years 1982 and 1984 with the Internal Revenue Service Center located in Kansas City, Missouri. Attached to Mr. Caulfield's returns for 1982 and 1984 was the Schedule C which reported business expenses.

The Commissioner of Internal Revenue mailed a notice of deficiency to Mr. Caulfield dated October 13, 1988. The Commissioner audited Mr. Caulfield's 1982 and 1984 returns. Mr. Caulfield's returns for the years 1983, 1985, 1986 and 1987 were also audited by the Commissioner.[1] Mr. Caulfield's return for 1982 was beyond the three year statute of limitations period but in the spirit of cooperation, Mr. Caulfield waived the limitation period. This extension allowed the Commissioner to audit Mr. Caulfield's 1982 return. The Commissioner determined that Mr. Caulfield's records were inadequate for the years 1982 and 1984 and consequently reconstructed Mr. Caulfield's income for those years. However, the Commissioner accepted Mr. Caulfield's record keeping methods for the years 1983, 1985, 1986 and 1987. These records were kept in the same manner as those in 1982 and 1984. The problems concerning the 1983, 1985, 1986 and 1987 returns were settled with the Commissioner.[2] If shown that he was required to do so, the Petitioner paid additional income taxes.

The Commissioner reconstructed Mr. Caulfield's income using the bank deposits plus cash expenditures method.[3] The

[1] The Commissioner never suggested that the Petitioner's record keeping methods were suspect. The Commissioner relied on these records to find the Petitioner liable for additional taxes in 1983.

[2] The Commissioner relied on the same record keeping methods in prior years and never suggested that the Petitioner's record keeping methods were suspect.

[3] Treas. Reg. §6001-1(e) requires that the books or records required by this Section [I. R. C. (§6001] shall be kept at all time available for the inspection by authorized internal revenue officer or employee and shall be retained so long as the contents there of may become material in the administration of any internal revenue law.

Commissioner first calculated the net bank funds available to pay Mr. Caulfield's business expenses for 1982 and 1984. She did this by subtracting nondeductible expenditures and bank account transfers from Mr. Caulfield's total bank account funds available in 1982 ($423,821 - $95,696 = $328,125), and 1984 ($1,600,831 - $893,091 = $707,740). The Commissioner then subtracted net bank funds on the Schedule C of Mr. Caulfield's Form 1040 ($375,365 in 1982 and $763,523 in 1984). The resulting derived amount was considered as business expenses not paid with deposited funds. The Commissioner then added that amount ($47,240 for 1982 and $55,783 for 1984) to Mr. Caulfield's net business bank deposits to arrive at his gross business receipts, $431,269 in 1982 ($384,029 + $47,240), and $827,228 in 1984 ($77,445 + $55,783). The Commissioner concluded that Mr. Caulfield had understated taxable income on his 1982 and 1984 returns by determining the difference between gross business receipts and the amounts Mr. Caulfield reported on his income tax return $431,269 - $380,731 totaling $50,538.00 in 1982, and $827,228 - $760,249 totaling $66,979.00 in 1984. The Commissioner of Internal Revenue also assessed self-employment taxes. Based on this reconstruction, the Commissioner assessed taxes and penalties for 1982 and 1984 as follows:

Year	Deficiency	§6653(a)(1)	§6653(a)(2)	§6661
1982	$21,974.00	$1,099.00	50% of the interest on $21,947.00	--
1984	$15,949.00	$797.00	50% of the interest on $15,949.00	$3,987.00

Petitioner has contended that the Commissioner overstated the amount of nondeductible expenditures in the form of personal living expenses and capital expenditures, thereby erroneously increasing the unreported income computed under the

bank deposits method. One of the items used to compute capital expenditures in 1982 was a Camero purchased for the price of $11,318.00. Mr. Caulfield maintained that he financed the Camero and did not pay the price outright as contended by the Commissioner. At trial before the Tax Court, the Petitioner was unable to locate the loan contract. Upon locating the contract among items once in the Commissioner's possession, the Petitioner sought to have this contract introduced as newly discovered evidence.[4] The Petitioner seeks to have the price of the Camero subtracted from the capital expenditures for the year 1982. In 1982, the Commissioner's bank deposit method worksheet projected Mr. Caulfield's personal living expenses at $83,135.00 and purchase of capital items to be $12,561.00. Mr. Caulfield has contended that the facts stipulated to, and the evidence adduced at trial, established that his personal expenses and capital items were considerably less than the nearly $96,000.00 alleged by the Commissioner. For 1984, the worksheet prepared by the Commissioner listed Mr. Caulfield's personal living expenses at $47,170.00, purchase of capital items totaling $22,002.00 and $10,601.00 paid in settlement of divorce. Mr. Caulfield has contended that his personal expenses were considerably less than the $47,170.00 that was alleged by the Commissioner. This was substantiated by the evidence presented at trial.

Petitioner has also contended that the Commissioner's recomputation of Petitioner's income failed to take into account the fact that he had nontaxable funds. The nontaxable funds included loan proceeds and a considerable understatement of the opening balance in Mr. Caulfield's various bank accounts. Further, the Commissioner failed to take into account the nontaxable income from an automobile accident and medical malpractice suit. Mr. Caulfield was unable to substantiate some of

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[4] The Petitioner's records were subpoenaed by the Commissioner. Those records obtained pursuant to the subpoena were only duplicates of documents already in the Commissioner's custody.

his assertions because of the passage of time and due to the expense of both time and money of locating documents which were many years old.[5] However, Mr. Caulfield's leads were easily traceable by the Commissioner. The auditors from the Internal Revenue Service went to great lengths in an attempt to seek out the petitioner's unreported income. The agents visited and questioned Mr. Caulfield's former wife and his real estate agent, but the Commissioner made no attempt to locate the leads provided concerning the malpractice suit and the automobile accident. Although the Tax Court agreed that the Commissioner had made several errors, it determined that these errors were not of such magnitude so as to conclude that the Commissioner's assessment was arbitrary. The Tax Court also did not require the Commissioner to seek out the information concerning the source of some income. The Tax Court, instead, placed the burden on the Petitioner to establish that he had nontaxable sources of income. The Eighth Circuit Court of Appeals agreed with the Tax Court and upheld the ruling of the Tax Court on this point.

The Petitioner urges that the Commissioner should not have reconstructed his income because his records were complete. In this Petition to the Tax Court the Petitioner stated that the reconstruction of his income was "improper." In his Petition to the Tax Court he also stated that "The Petitioner's taxable income was erroneously increased by $66,979.00. That the "Income Bank Deposit Method" was used to calculate the increase in Petitioner's gross income, although other evidence was clearly available to the Internal Revenue agent to substantiate all entries on Petitioner's 1984 individual income tax return." The same language was used for 1982 as well. The Petitioner has also contended that since the Commissioner accepted the Petitioner's records as adequate in prior years they

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[5] To extend the Commissioner's authority to reconstruct the Petitioner's income where his records were complete would give the Commissioner authority far beyond the authority contemplated by our tax laws.

should have been adequate in 1982 and 1984 as well. The Petitioner believes that the language used in his Petition adequately raised the issue in the Tax Court. The Tax Court did not take his contention seriously and the Eighth Circuit held that this issue was not properly preserved. The Eighth Circuit further held that even if the issue had been raised, it found that the reconstruction appropriate because Petitioner's records were complete only on their face.

The Eighth Circuit also determined that the Tax Court's findings regarding the assessment were not clearly erroneous, and that the Commissioner's reconstruction was entitled to a presumption of correctness despite some errors.

Mr. Caulfield also argued that the Tax Court erred in sustaining the imposition of penalties under Sections 6653 and 6661 of the Internal Revenue Code. The court sustained the imposition of the penalties.

REASONS FOR GRANTING THE WRIT

This Petition for Writ of Certiorari is submitted to this Honorable Court on the issue of whether the Commissioner's assessment was flawed because of numerous errors and miscalculations made during the reconstruction of the Petitioner's income. The Tax Court and the Eighth Circuit Court of Appeals gave the Commissioner the benefit of the presumption despite the numerous errors. Because of the many errors made by the Commissioner, the Petitioner urges that the assessment should not have been entitled to the presumption of correctness usually afforded a sound assessment.

The first issue before this Court is whether the Petitioner properly preserved the issue of the adequacy of his records. It is a general rule that a federal appellate court will not consider an issue not passed upon below. *Greyhound Lines, Inc. v. Morrow*, 541 F. 2d 713, 724 (8th Cir. 1976). In Petitioner's case, the court erred in determining that the Petitioner had not raised the issue of the adequacy of his records. While it is true that the Petitioner did not focus on the adequacy issue he did not ignore it. The Tax Court stated that the Petitioner did not "seriously question" the Commissioner's authority to reconstruct his income. This statement indicates the extent to which the Petitioner raised the adequacy issue. It should not be important to the court as to what degree the Petitioner raised the issue, but whether the adequacy issue was raised at all.

The purpose of the rule as stated in *Greyhound Lines, Inc. v. Morrow*, is to enforce the policy that requires litigants to inform the trial court promptly of any possible errors that it may have an opportunity to correct them. *Edwards v. Hurtel*, 724 F. 2d 689, 690 (8th Cir. 1976). Not only was the issue raised by the Petitioner, but the issue was raised by the Commissioner and the Tax Court was, therefore, fully aware of it. Moreover, this Court in *Singleton v. Wulff*, 428 U. S. 106, 121, 96 S. Ct. 2868, 2877,

49 L.Ed. 826 (1976) recognized that there may be exceptions to the rule such as "where the proper resolution is beyond any doubt . . . or where 'injustice might otherwise result'."

The Petitioner believes that there are limits on the Commissioner's authority to reconstruct income. There is no indication in this case that the Petitioner's records were inadequate or inaccurate. To extend the Commissioner's authority to reconstruct a taxpayer's income where records were complete would give the Commissioner authority far beyond that contemplated by our tax laws. It is important that the Court make a determination on this issue. The Petitioner urges that a great injustice has been done in his case because of the often baseless and arbitrary reconstruction of his income.

It well established that taxpayers are required to keep adequate books from which their correct tax liability may be determined. I.R.C. § 6001. However, taxpayers are not required to keep records past a specified time period. At the time of the Appellant's audit as now, C.F.R. § 31.6001-1(e) requires taxpayers to keep their records for four years after the date for which the return relates, or four years after the date that the claim is filed if the taxpayer is due a refund. Therefore, Petitioner was not even required to produce records for the year 1982. Considering that the Petitioner was not even legally obligated to retain his records, it is far beyond reason that the Commissioner has asserted that the Petitioner's records were inadequate or that the Petitioner's records were only facially correct.

Where no adequate records are present, the Commissioner may reconstruct taxable income by any reasonable method. I.R.C. § 446(b), *Dodge v. Commissioner*, 981 F. 2d 350 (8th Cir. 1992). The Commissioner may also reconstruct a taxpayer's income in a case where a taxpayer is uncooperative and not forthcoming. *Petzoldt v. Commissioner*, 92 T.C. 661 (1989). Even when a taxpayer keeps books and records that on their face

are consistent with and support a return as filed, the Commissioner may determine the taxpayer's income through indirect methods. *Holland v. United States*, 348 U.S. 121, 132 (1954); *Schwartzkopf v. Commissioner*, 246 F. 2d 731, 733-734 (1957). However, these cases do not address the issue of Mr. Caulfield's case; whether once the Commissioner has accepted a taxpayer's records as adequate in one year may she then not accept the same records as adequate in another year, *Presumption of correctness issue.....*

The Commissioner's method of calculating income is presumptively correct and will be affirmed so long as it is rationally based. *Rowell v. Commissioner*, 884 F. 2d 1085 (8th Cir. 1989). The burden is then on the taxpayer to show that the determination was wrong. *Id* at 1087. However, the Commissioner must have some reasonable foundation for the assessment to preserve the presumption of correctness. *Erickson v. Commissioner*, 937 F. 2d 1548 (10th Cir. 1991); *Jones v. Commissioner*, 903 F. 2d 1301 (10th Cir. 1990); *Weimerskirch*, 596 F. 2d 358 (9th Cir. 1979). The presumption is no more than a permissible inference which the Commissioner may draw in attempting to ascertain the existence of a deficiency. *Armes v. Commissioner*, 448 F. 2d 972, 975 (5th Cir. 1971).

In this case, the Tax Court gave the Commissioner the benefit of the inference without requiring the Commissioner to show any rational basis for its method of determining the deficiency. Where the record reflects no reasonable basis for the Commissioner's assessment, and where the assessment cannot be deemed reasonable on its face, and where no finding is made in that regard, the presumption of correctness does not attach automatically to the assessment. *Denison v. Commissioner*, 689 F. 2d 772 (8th Cir. 1982). The Commissioner must do more than calculate income based on speculation, as was done in this case. *See Cummings v. Commissioner*, 410 F. 2d 675 (5th Cir. 1969). The Tax Court noted that many mistakes had been made by the

Commissioner, but found them harmless. For instance, the Tax Court found that the Commissioner had understated the Petitioner's opening balances. The availability of more money in the Petitioner's bank increased the amount of nontaxable funds. Errors were simply overlooked. Under some circumstances the Commissioner is not required to achieve "mathematical exactitude" *Harper v. Commissioner,* 54 T.C. 1211, 1129 (1970). However, as the court in *Cummings* stated that "the absence of adequate tax records does not give the Commissioner carte blanche for imposing Draconian absolutes." [Citations omitted.] *Id* at 679. The Commissioner's assessment was flawed. The errors in the Petitioner's case are not minor and they are not harmless because Mr. Caulfield faces extensive liability based on the Commissioner's faulty assessment. The Petitioner urges that cases such as *Harper* are not applicable when the errors are so great. The Petitioner urges that the magnitude of the errors requires that presumption of correctness not attach to the Commissioner's assessment.[6] The Petitioner urges that there must be some accuracy if the Commissioner is to be entitled to the presumption of correctness. *Cummings*, 410 F. 2d at 679.

To ensure accuracy when inferential methods are used in reconstructing income, the IRS must investigate reasonable leads furnished by a taxpayer. *Holland v. United States*, 348 U. S. 121, 135-36, 75 S. Ct. 127, 135, 99 L. Ed. 2d 150 (1954). *See also Edelson v. Commissioner*, 829 F. 2d 828 (9th Cir. 1987). As the Court in *Holland* explained that "when the Government rests its' case solely on the approximations and circumstantial inferences . . . the cogency of its proof depends upon its' effective negation of reasonable explanations by the taxpayer inconsistent

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[6] This case may be an exception to the rule that the burden of proof shall be on the taxpayer pursuant to Tax Court Rule 142 since Commissioner increased the deficiency assessment.

with guilt."[7] Of course, leads need not be followed if the information was difficult to obtain or would not assist a taxpayer's case. *United States v. Chu*, 779 F. 2d 356 (7th Cir. 1985). Clearly any evidence of nontaxable income would have been helpful to the Petitioner.

Mr. Caulfield provided information to the Commissioner that he had settled a medical malpractice suit and an automobile accident claim which produced substantial nontaxable income. None of these sources were investigated by the Commissioner, even though records were readily available and could have been easily checked.

There is no evidence that the Commissioner made any attempt to seek out nontaxable income other than several loans. Throughout this litigation this position was urged by the Petitioner. Tax Court erroneously determined that Mr. Caulfield bears the burden of proving he realized such nontaxable income. *Parks v. Commissioner*, 94 T.C. 654 (1990); *Tokarski v. Commissioner*, 87 T.C. 74 (1986). *Parks* and *Tokarski* were 'source of income' cases and dealt with situations of illegal or suspect activity. They stand for the proposition that the Commissioner does not have to demonstrate a likely taxable source for the money deposited in a taxpayer's account once it proves a likely source of income. *Erickson v. Commissioner*, 937 F. 2d at 1554. The issue in *Parks* and *Tokarski* was whether there was any evidence linking deposits of money with some profit-making venture. *Anaya v.*

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[7] Although *Holland* was a criminal case and the Commissioner is required to satisfy a less stringent standard in civil case, only the quantum of proof is affected. This does not relieve the Commissioner of her burden of proving a likely source of taxable income. *Hoffman v. Commissioner*, 298 F. 2d 784, 787 (3d Cir. 1962). *Holland* has been consistently interpreted to require the Commissioner to eliminate all nontaxable sources of income. *United States v. Slutsky*, 487 F. 2d 832 (2d Cir. 1973), *cert. denied*, 416 U. S. 937, 94 S. Ct. 1937, 40 L. Ed. 2d 287 (1974); *United States v. Boulet*, 577 F. 2d 1165 (5th Cir. 1978), *cert. denied*, 439 U. S. 114, 90 S. Ct. 755, 24 L. Ed. 2d 754 (1979).

Commissioner, 983 F. 2d 186 (10th Cir. 1993). This was never an issue in Mr. Caulfield's case. Mr. Caulfield is a businessman and his income ordinarily would have come from the operation of his business. The issue in Mr. Caulfield's case is whether the Commissioner must eliminate a nontaxable source of income once the Commissioner has been notified of it. Mr. Caulfield contends that the Commissioner must eliminate sources of nontaxable income. In *Holland*, this Court required that the Commissioner do so and it was not done in the Petitioner's case. The Tax Court clearly erred in not requiring the Commissioner to investigate the leads provided to the Commissioner. The Eighth Circuit completely ignored this problem with the Commissioner's assessment.

The Camero was purchased on December 27, 1982. The Commissioner's position on the contract is that it is immaterial because the amount was deducted from her calculation as a nontaxable loan in the amount of $10,000 dated December 20, 1982. The Petitioner argues that the amount was not deducted because the Commissioner merely assumed that a loan was made for the purpose of purchasing the Camero. The Commissioner had no evidence whatsoever to have concluded that these amounts were one and the same. This was only an assumption on the Commissioner's part. There is absolutely no basis for that assumption and it illustrates the problems with the reconstruction of the Petitioner's income. In *Cummings*, the Commissioner reconstructed the taxpayer's income without the aid of any information other than bank records for certain years and used the bank deposits computation method. The Commissioner had access to bank records for 1956-1958. The Commissioner applied average net profits for 1956-1958 to deposits for the years 1944-1955 to determine annual income. The Court held that although that taxpayer had failed to keep the necessary records, the Commissioner was not entitled to the presumption of correctness. It was arbitrary for the Commissioner to have applied the 1956-58 average to the 1944-55 calculation. The

court of appeals incorrectly concluded that because the loan was not referred to as an installment contract, although it was clearly labeled as such, that it should not be treated as a loan.

The Petitioner contends that because the Commissioner was operating a dubious assumption, loan proceeds were therefore treated as income to the Petitioner. This Court has consistently held that loan proceeds are not treated as income. *Commissioner v. Tufts*, 461 U. S. 300, 307 (1983); *Commissioner v. Indianapolis Power & Light Co.*, 493 U. S. 203, 207 (1990). The Petitioner contends that the inclusion of the purchase price of the Camero as a capital expenditure directly conflicts with the Courts decision in *Tufts* and *Indianapolis Power & Light Co.*

The Tax Court sustained the Commissioner's determination that Mr. Caulfield was liable for additions to tax for negligence pursuant to I.R.C. §6653(a)(1) and 6653(a)(2), since repealed. For the years 1982 and 1984 section 6653(a)(1) imposed an addition to tax equal to 5 percent of the underpayment, if any part of the underpayment for the year is due to a taxpayer's negligent or intentional disregard of the internal revenue code. Section 6653(a)(2) imposed an addition to tax equal to 50 percent of the interest payable under I.R.C. §6601 with respect to any portion of the underpayment which is attributable to the negligence or intentional disregard of the internal revenue code.

Generally, a taxpayer has the burden of disproving negligence *Edison Homes, Inc. v. Commissioner*, 903 F. 2d 579, 584 (8th Cir.), *cert. denied*, 498 U. S. 984 (1990); *Allen v. Commissioner*, 925 F. 2d 348, 353 (9th Cir. 1991). The Commissioner's imposition of the negligence penalty is presumptively correct. *Gibbs v. Tomlinson*, 362 F. 2d 394, 399 (5th Cir. 1966). However, if the burden is on Mr. Caulfield to prove that he was not negligent for understating his income, the Petitioner contends that Commissioner must make some initial showing for the imposition of the penalty. In *Weimerskirch v. Commissioner*, 596 F. 2d at 361. The Petitioner contends that this would apply

to any presumption including the presumption of negligence. The Commissioner cannot prove her case by mere innuendo. The Commissioner's only evidence on the issue of negligence was that Mr. Caulfield hired someone to assist him with preparing his tax returns that was known to get the "best deductions." Not only was this evidence prejudicial but irrelevant. It is well established that a taxpayer may arrange his affairs so that his taxes will be as low as possible and is not bound to choose a pattern which will best pay the Treasury. *Helvering v. Gregory,* 69 F. 2d 809, 810 (2d Cir. 1934) (Hand, J. Learned), *aff'd* 293 U.S. 465, 55 S. Ct. 266, 79 L. Ed. 596 (1935).

The Commissioner imposed the penalty because the Petitioner had been negligent in failing to report all of his income. Failing to report income does not necessarily result from negligence. Perhaps the Petitioner's record keeping method arguably failed him despite his best efforts. Taxpayers that act in good faith and have an honest misunderstanding of the law and fact should not have negligence penalty imposed on them. *Heasley v. Commissioner,* 902 F. 2d 380, 384 (5th Cir. 1990). This occurred in *Norgaard v. Commissioner*, 939 F. 2d 874 (9th Cir. 1991). In *Norgaard* the taxpayer gambled and the method he used for determining his winnings and losses entailed keeping all receipts and losing tickets in a brown paper bag. If at the end of the year, cash remained in the bag, he would tally it and report the winnings. If only losing tickets remained, he would report a loss. This method was ultimately determined to be an inaccurate way of measuring income. The court determined that the method, although inaccurate, was logical and not an unreasonable one and therefore the penalties were inappropriate. The Petitioner made his best efforts to keep track of and report his income. The Petitioner was not playing the audit lottery and there was nothing in the record to suggest that he was doing so. The Petitioner maintains he employed a logical method of record keeping designed to record all of his income. Though arguably imprecise, the Petitioner did his best to maintain adequate records that

accurately reflected his income just as had the taxpayer in *Norgaard. Norgaard* demonstrates that the Commissioner cannot simply assert negligence. The outcome in *Norgaard* is at odds with the outcome in the Petitioner's case. The Petitioner was deemed negligent for simply understating his income. There was absolutely no showing that the Petitioner acted negligently. Negligence rested solely on the Commissioner's assertion that the Petitioner's return is incorrect. A finding that a return is incorrect is not enough to impose the negligence penalty. *See e. g. Bennett v. Commissioner,* 139 F. 2d 961 (8th Cir. 1944) (interpreting 26 U. S. C. 293, predecessor of section 6653(a)(2).

The Tax Court sustained the §6661(a) addition to tax in an amount equal to 25 percent of the amount of any underpayment attributed to substantial understatement of income tax for 1984. Mr. Caulfield made an honest and reasonable attempt to record all of his income and has maintained that the assessment was wrong. Mr. Caulfield sought to have his income fairly redetermined.[8] There is no evidence that the Petitioner acted on any motives other than the best intentions. Further, since Mr. Caulfield's income cannot be calculated with exactitude, he should not be liable for the addition to tax pursuant to §6661(a). The Petitioner contends that he established that he acted in good faith and therefore the penalties under §6661 should not be imposed. Further, no additional tax should be imposed on a taxpayer who acted in good faith. *See e.g. Heasley v. Commissioner*, 902 F. 2d at 384. *And see Norgaard v. Commissioner*, 939 F. 2d at 879-880.

To allow the decision of the Tax Court as affirmed by the Eighth Circuit to stand would confer the Commissioner with

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[8] Mr. Caulfield has maintained throughout this litigation that the IRS was not acting fairly. He believed the audit process was being used to retaliate against him for his criticisms of another federal agency.

arbitrary authority far beyond the *Presumption of Correctness*, normally afforded to her findings. Such a decision would allow the Commissioner to disregard all taxpayer's records, regardless of how complete, and to include loans as taxable income. The decision further allows the Commissioner to make arbitrary and capricious assessments for negligence and additional tax, even when the taxpayer demonstrated good faith and has cooperated fully with her.

CONCLUSION

For these reasons the Court should grant this petition for certiorari and, upon review, the judgment of the Court of Appeals should be reversed.

Respectfully submitted,

Jerry L. Suddarth
Counsel of Record for Petitioner
Suddarth & Koor
755 West Terra Lane
O'Fallon, MO 63366

(314) 272-7644

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APPENDIX

APPENDIX A

T.C. Memo. 1993-423

UNITED STATES TAX COURT

JOSEPH P. CAULFIELD, Petitioner *v.*
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 304-89, 305-89

Filed September 14, 1993.

Jerry L. Suddarth, for petitioner,
Anthony S. Gasaway, for respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

WHALEN, *Judge:* Respondent determined deficiencies in, and additions to, petitioner's Federal income tax for 1982 and 1984, as follows:

		Additions to Tax		
Year	Deficiency	Sec. 6653(a)(1)	Sec. 6653(a)(2)	Sec. 6661
1982	$21,974	$1,099	50% of the interest due on $21,974	--
1984	15,949	797	50% of the interest due on $15,949	$3,987

All section references are to the Internal Revenue Code in effect for the years in issue.

The issues for decision are: (1) Whether petitioner realized unreported income of $50,538 in 1982, and $66,979 in 1984, as determined by respondent: (2) whether petitioner is liable for self-employment tax pursuant to section 1401; (3) whether

petitioner is liable for additions to tax for negligence pursuant to section 6653(a)(1) and (2); and, (4) whether petitioner is liable for the addition to tax for substantial understatement of his 1984 tax pursuant to section 6661.

FINDINGS OF FACT

The parties have stipulated some of the facts in these cases. The Stipulation of Facts and the Supplemental Stipulation of Facts filed by the parties, and the exhibits attached thereto, are hereby incorporated herein by reference. The oral stipulations recited by the parties at the start of trial are also incorporated herein by reference. Petitioner resided in St. Peters, Missouri, at the time each of the petitions which are at issue in these cases was filed on his behalf.

During the years in issue, petitioner was engaged in the business of being a public insurance adjuster. He pursued that activity as a sole proprietor. For Federal income tax purposes, petitioner reported income and deductions under the cash receipts and disbursements method of accounting. Attached to petitioner's Federal income tax returns for 1982 and 1984 are Schedules C, Profit or (Loss) From Business or Profession, which report the following income and deductions from his public insurance adjuster business:

	1982	1984
Gross receipts	$380,891.55	$760,249
Cost of Goods Sold	(160.35)	—
Total income	380,731.20	760,249
Advertising	5,762.36	11,836
Bank service charges	482.00	596
Car and truck expenses	8,802.90	11,829
Commissions	52,897.17	132,894
Depreciation	5,013.65	9,677
Dues and publications	761.31	2,848
Employee benefit programs	3,447.76	12,818
Freight	2,400.00	—
Insurance	2,679.00	7,000
Int. on bus. indebtedness	9,513.69	14,082
Laundry and cleaning	850.00	—
Legal and prof. service	21,146.48	17,822
Office supplies and postage	4,671.58	6,577
Rent on bus. prop.	6,641.00	9,546
Repairs	2,068.28	2,202
Supplies	6,446.20	2,891
Taxes	3,710.68	7,637
Travel and entertainment	25,652.37	25,930
Utilities and telephone	8,115.99	14,568
Wages	20,140.00	18,172
Escrow	173,851.15	446,552
Board up and Temp.	4.925.40	8,853
Son's labor	2,600.00	—
Business church	780.00	—
Political contribution	615.00	—
Christmas party	1,556.25	—
Business charities	3,808.92	—
Misc. general $20/week	1,040.00	2,080
Other expenses	—	6,790
Total deductions	380,379.14	773,200
Net profit or (loss)	352.06	(12,951)

Respondent audited petitioner's 1982 and 1984 returns, and found an "absence of adequate records" from which to compute petitioner's taxable income. Accordingly, respondent reconstructed petitioner's income using the bank deposits plus cash expenditures method.

Petitioner maintained two bank accounts during 1982. He maintained an account at the Brentwood Bank in St. Louis Missouri (the first Brentwood account), which he used primarily, but not exclusively, for business purposes. He also maintained an account at the Southwest Federal Bank in St. Louis, Missouri (the Southwest account), which he used for personal purposes.

During the audit of petitioner's returns, respondent's agent found that the balances of the above accounts on January 1, 1982, the total deposits made to the accounts during 1982, the transfers between the accounts during 1982, the deposit of loan proceeds into the accounts during 1982, the aggregate checks written on the accounts in 1981 that were outstanding at the beginning of 1982, the aggregate checks written in 1982 that were outstanding at the end of 1982, and the balances of the accounts at the end of 1982, were as follows:

	First Brentwood Account	Southwest Account	Total
Balance 1/1/82	—	$2,259	$2,259
Total deposits made in 1982	$394,029	43,018	437,047
Transfers between accounts	—	—	23,018
Deposit of loan proceeds	10,000	20,000	30,000
Check written in 1981 outstanding on 1/1/82	—	—	—
Checks written in 1982 outstanding on 12/31/82	—	—	—
Balance 12/31/82	5,492	9,993	15,485

Based upon the stipulations of the parties, we find that the correct amounts are set out below:

	First Brentwood Account	Southwest Account	Total
Balance 1/1/82	$18,984.26	$1,772.21	$20,756.47
Total deposits made in 1982	393,608.35	44,004.66	437,613.01
Transfers between accounts	—	21,600.00	21,600.00
Deposit of loan proceeds	10,000	20,000	30,000
Check written in 1981 outstanding on 1/1/82	2,858.87	1,251.19	4,110.06
Checks written in 1982 outstanding on 12/31/82	866.34	257.26	1,123.60
Balance 12/31/82	5,492.30	5,237.16	10,729.46

Petitioner maintained four bank accounts during 1984. They included the first Brentwood account and the Southwest account mentioned above. Petitioner also maintained a second account at the Brentwood Bank (the second Brentwood account) which, like the first Brentwood account, he used primarily, but not exclusively, for business purposes. He maintained an account at the St. John's Bank in St. Louis, Missouri (the St. John's account), under the name "John R. Caulfield". The record does not explain why petitioner maintained this account under a different name, or the purpose of the account.

Respondent's agent found that the balances of the above accounts on January 1, 1984, the total deposits made to the accounts during 1984, the transfers between the accounts during 1984, the aggregate checks written on the accounts in 1983 that were outstanding at the beginning of 1984, the aggregate checks written in 1984 that were outstanding at the end of 1984, and the balances of the accounts at the end of 1984 were as follows:

	First Brentwood Account	Southwest Account	Second Brentwood Account	St. John's Account	Total
Balance 1/1/84	$10,821	$1,298	$11,719	$60,403	$84,241
Total deposits made in 1984	714,509	23,691	858,563	—	1,596,763
Transfers between accounts	554,113	9,200	262,005	—	825,318
Checks written in 1983 outstanding on 1/1/84	45,989	307	—	—	46,296
Checks written in 1984 outstanding on 12/31/84	7,184	—	—	—	7,184
Balance 12/31/84	6,822	2,916	3,508	27,815	41,061

Based upon the stipulations of the parties, we find that the correct amounts are set out below:

	First Brentwood Account	Southwest Account	Second Brentwood Account	St. John's Account	Total
Balance 1/1/84	$10,821.00	$1,298.00	$11,719.00	$60,403	$84,241.00
Total deposits made in 1984	829,855.83	23,691.00	602,462.63	—	1,456,009.46
Transfers between accounts	593,112.91	9,200.00	73,508.00	—	675,820.91
Checks written in 1983 outstanding on 1/1/84	45,989.37	307.00	—	—	46,296.37
Checks written in 1984 outstanding on 12/31/84	7,153.63	—	—	—	7,153.63
Balance 12/31/84	6,822.00	2,976.35	3,508.00	27,815	41,121.35

Parenthetically, we note that during 1984 petitioner maintained a third account at the Brentwood Bank. The balance of the account was $80,000 on January 1, 1984, and on December 31, 1984, and no deposits were made to the account during the year. This account is not included in the above discussion because it does not affect respondent's reconstruction of petitioner's income under the bank deposits method. Nevertheless, we note that the beginning and ending balances set out above are $80,000 less than the amounts used by the agent.

Respondent's agent found that during 1982 and 1984 petitioner spent $83,135 and $57,771, respectively, for personal living expenses. The agent also found that during 1982 and 1984, petitioner spent $12,561 and $22,002, respectively, to purchase capital assets.

In the notice of deficiency, respondent determined that petitioner's net deposit of business receipts during 1982 amounted to $384,029. Based upon the stipulations of the parties, we find that the correct amount is $386,013.01. Set out below is respondent's computation as contained in the notice of deficiency, and the same computation using the amounts that were stipulated by the parties:

1982	Notice of Deficiency	Revised
Total Deposits:		
First Brentwood account	$394,029	$393,608.35
Southwest account	43,018	44,004.66
	437,047	437,613.01
Less:		
Loan proceeds	30,000	30,000.00
Transfers between accounts	23,018	21,600.00
Net deposit of business receipts	384,029	386,013.01

In the notice of deficiency, respondent also determined that petitioner's net deposit of business receipts during 1984 amounted to $771,445. Based upon the stipulations of the parties, we find that the correct amount if $780,188.55. Set out below is respondent's computation as contained in the notice of deficiency, and the same computation using the amounts that were stipulated by the parties:

1984	Notice of Deficiency	Revised
Total Deposits:		
First Brentwood account	$714,509	$829,855.83
Second Brentwood account	858,563	602,462.63
Southwest account	23,691	23,691.00
St. John's account	—	—
	1,596,763	1,456,009.46
Less:		
Loan proceeds	—	—
Transfers between accounts	825,318	675,820.91
Net deposit of business receipts	771,445	780,188.55

In the notice of deficiency, respondent determined that the total funds available in petitioner's bank accounts during 1982 was $423,821. Based upon the stipulations of the parties at trial, we find that the correct amount is $444,653.56. Set out below is respondent's computation as contained in the notice of deficiency, and the same computation using the amounts that were stipulated by the parties:

1982	Notice of Deficiency	Revised
Opening balances	$2,259	$20,756.47
Plus: total deposits	437,047	437,613.01
Less: closing balances	15,485	10,729.46
Plus: checks outstanding—current year	—	1,123.60
Less: checks outstanding—prior year	—	4,110.06
Total	423,821	444,653.56

In the notice of deficiency, respondent also determined that the total funds available in petitioner's bank accounts during 1984 were $1,600,831. Based upon the stipulations of the parties at trial, we find that the correct amount if $1,459,986.37. Set out below is respondent's computation as contained in the notice of deficiency, and the same computation using the amounts that were stipulated by the parties:

1984	Notice of Deficiency	Revised
Opening balances	$164,241	$84,241.00
Plus: total deposits	1,596,763	1,456,009.46
Less: closing balances	121,061	41,121.35
Plus: checks outstanding—current year	7,184	7,153.63
Less: checks outstanding—prior year	46,296	46,296.37
Total	1,600,831	1,459,986.37

In the notice of deficiency, respondent computed the funds which petitioner had available in his bank accounts during 1982 after subtracting the nondeductible expenditures made during the year from those accounts. We refer to this amount as the net funds available in 1982. Set out below is respondent's compu-

tation as contained in the notice of deficiency, and a revised computation based upon the stipulations of the parties:

1982	Notice of Deficiency	Revised
Total funds available	$423,821	$444,653.56
Less: nondeductible expenditures:		
personal living expenses	83,135	83,135.00
capital expenditures	12,561	12,561.00
transfers between accounts	—	21,600.00
Net funds available for 1982	328,125	327,357.56

Similarly, in the notice of deficiency, respondent computed the funds which petitioner had available in his bank accounts during 1984 after subtracting the nondeductible expenditures made during the year from those accounts. We refer to this amount as the net funds available in 1984. Set out below is respondent's computation as contained in the notice of deficiency, and a revised computation based upon the stipulations of the parties:

1984	Notice of Deficiency	Revised
Total funds available	$1,600,831	$1,459,986.37
Less: nondeductible expenditures:		
personal living expenses	57,771	57,771.00
capital expenditures	22,002	22,002.00
transfers between accounts	813,318	675,820.91
divorce settlement		
Net funds available for 1984	707,740	704,392.46

The parties agree that based upon the deductions claimed on the Schedules C filed by petitioner for 1982 and 1984, petitioner deducted cash expenditures in the following amounts:

	1982	1984
Total deductions on Schedule C	$380,379.14	$773,200
Less: depreciation	5,013.65	9,677
Cash expenditures reflected on Schedule C	375,365.49	763,523

The cash expenditures reflected on petitioner's Schedules C, as computed above, exceed the net funds available in petitioner's bank accounts. The computation of that excess for each of the years in issue as set forth in the notice of deficiency is as follows:

	1982	1984
Schedule C expenses paid in cash	$375,365	$763,523
Net funds available for business expenditures	328,125	707,740
Business expenses paid with undeposited funds	47,240	55,783

Respondent determined that the above excess for each year consists of business expenses paid by petitioner with funds that had not been deposited into one of petitioner's bank accounts. Accordingly, respondent added the above amounts to the net deposit of business receipts to arrive at petitioner's gross business receipts. The gross business receipts, as thus computed, are more than the gross business receipts reported on petitioner's Schedules C. That computation is as follows:

	1982	1984
Business expenditures paid by cash	$47,240	$55,783
Net deposits from business receipts	384,029	771,445
Gross business receipts	431,269	827,228
Less: gross receipts reported on return	380,731	760,249
Amount unreported	50,538	66,979

Based upon the above, respondent determined that petitioner had understated the gross income realized from his public adjuster business, as reported on Schedule C, by $50,538 in 1982 and $66,979 in 1984.

OPINION

Unreported Income

In auditing petitioner's income tax returns for 1982 and 1984, respondent found an "absence of adequate records" from which to compute petitioner's taxable income, and respondent invoked the authority delegated under section 446(b) to reconstruct petitioner's income using the bank deposits plus cash expenditures method, described above. Based upon such reconstruction, respondent determined that petitioner had underreported his business income by $50,538 in 1982, and $66,979 in 1984. Petitioner bears the burden of proving that respondent's determination is wrong. Rule 142, Tax Court Rules of Practice and Procedure; e.g., *Estate of Mason v. Commissioner,* 64 T.C. 651, 656-657 (1975), affd. 566 F.2d 2 (6th Cir. 1977).

Petitioner does not challenge respondent's finding of inadequate records or otherwise seriously question respondent's authority to reconstruct his income "under such method as, in the opinion of the Secretary, does clearly reflect income." Sec.

446(b). In fact, petitioner has stipulated all of the pertinent information regarding his bank accounts in 1982 and 1984. The principal dispute between the parties involves petitioner's contentions that respondent's reconstruction overstates the amount of nondeductible expenditures made by petitioner during each of the years in issue and fails to take into account nontaxable sources of income. We shall address petitioner's arguments for each year below.

At the outset, it is necessary to address three other issues raised by petitioner. First, petitioner renews his objection to the admission of the Statement of Income and Expenses of Joseph P. Caulfield filed in the Circuit Court for the County of St. Charles, Missouri, in a proceeding styled "Re the Marriage of Joseph P. Caulfield, Petitioner and Glenda Ruth Caulfield, Respondent," number CV183-1213DR. Petitioner argues, without citing any authority, that the document cannot be admitted into the record of these cases:

> for lack of a proper foundation. the [sic] document purports to be a copy "certified" by a Deputy Clerk from the Circuit Clerk in St. Louis County, Missouri. Petitioner submits that to be used in this proceeding the docket and signature of the certifying clerk had to be "authenticated" by the Circuit Clerk for said Court. This "authorization" is accomplished by the Circuit Clerk indicating that she is the Circuit Clerk and that the Deputy Clerk prepared the document at her direction and that it is a true copy of same.

We disagree. The subject document bears the official seal of the Circuit Court of St. Charles County, Missouri, and a stamp which states as follows:

> **CERTIFICATE OF TRUE COPY**
>
> I, Susan E. Brown, Clerk of Circuit Court, within and for the County of St. Charles, State of Missouri, do certify that the

foregoing is a true copy of an original document remaining on file and record in my office. Witness my hand and SEAL of said court this 2 DAY OF MARCH, 1990.

SUSAN E. BROWN BY LESLIE EISENSTEIN
SUSAN E. BROWN, CLERK DEPUTY

The certification purports to have been signed by a deputy clerk of the circuit court.

The above certificate complies with rule 902(4) of the Federal Rules of Evidence under which extrinsic evidence of authenticity is not a condition precedent to admissibility. Rule 902(4) of the Federal Rules of Evidence provides as follows:

> Extrinsic evidence of authenticity as a condition precedent to admissibility is not required with respect to the following:
>
> > (1) Domestic public documents under seal. A document bearing a seal purporting to be that of the United States, or of any state, district, Commonwealth, territory, or insular possession thereof, or the Panama Canal Zone, or the Trust Territory of the Pacific Islands, or of a political subdivision, department, officer or agency thereof, and a signature purporting to be an attestation or execution.
> >
> > * * * * * * *
> >
> > (4) Certified Copies of Public Records. A copy of an official record or report or entry therein, or of a document authorized by law to be recorded or filed and actually recorded or filed in a public office, including data compilations in any form, certified as correct by the custodian or other person authorized to make the certification, by certificate complying with paragraph (1), (2) or (3) of this rule * * *.

The subject certification bears the official seal of the circuit court and the signature of a deputy clerk of that court. This is all that rule 902(4) requires. We find nothing in rule 902(4) to require an additional certification as to the authority of the deputy clerk. Cf. *United Stated v. Beason*, 690 F.2d 439, 444 (5th Cir. 1982).

The second preliminary point is petitioner's argument that he was denied an opportunity for administrative consideration of these cases. His entire argument on this point is as follows:

> Furthermore, the Respondent, in this case, violated IRS procedures and guidelines. No notice was given to Petitioner of "income tax examination changes". The [sic] statutory Notice of Deficiency * * * was the first written notice of any change in Petitioner's tax liability for 1982. As a result, Petitioner was deprived of any opportunity to pursue administrative relief afforded by the Respondent's own guidelines.

Our first difficulty with the above argument is that petitioner did not introduce into the record of these cases any evidence to prove the factual contentions that the notice of deficiency was the first notice given to him of any change in his 1982 tax, and that he did not receive administrative consideration of his cases. Moreover, petitioner does not explain what relief, if any, he is entitled to receive as a result of having been deprived of administrative consideration of his cases, or the legal basis for such relief. In other cases in which the taxpayer was not afforded an administrative hearing prior to the issuance of the notice of deficiency, we have upheld the validity of the notice. See *Boyer v. Commissioner*, 69 T.C. 521, 543-544 (1977); *Rimple v. Commissioner*, T.C. Memo. 1985-245. Similarly, we see no basis to give petitioner relief in these cases.

Finally, petitioner complains about the fact that there are differences between the amounts of bank deposits found in the subject notice of deficiency and the amounts stipulated by the

parties at trial. While we note the differences, we disagree with petitioner's argument that they prove "that the bank deposit method is totally inaccurate and improper method of attempting to calculate Petitioner's liability." To the contrary, it is clear that, in reconstructing a taxpayer's income, the Commissioner is not required to achieve "mathematical exactitude". E.g., *Petzoldt v. Commissioner*, 92 T.C. 661, 693-694 (1989); *Harper v. Commissioner*, 54 T.C. 1121, 1129 (1970). Furthermore, as discussed below, the unreported income determined by respondent for each of the years in issue is less than the amounts that would have been determined using the deposits stipulated by the parties. This suggests that respondent took a conservative approach in determining the amount of income omitted from petitioner's returns. We find no fault in respondent's approach in these cases.

1982 Taxable Year

Respondent found that the expenditures made by petitioner during 1982 exceeded the funds which were available in his bank accounts by $47,240. Respondent added that excess to the net deposits that had been made during the year, $384,029, and, thereby, determined that petitioner's gross receipts from his business amounted to $431,269, $50,538 more than the amount reported on Schedule C of his 1982 return, $380,731. The following is a summary of respondent's reconstruction of petitioner's income for 1982 as determined in the notice of deficiency and as revised in accordance with the stipulations of the parties:

1982 Summary		Notice of Deficiency	Revised	
Funds available in banks		$423,821		$444,653.56
Deductible expenditures	$375,365		$375,365.14	
Non-deductible expenditures:				
Personal living expenses	83,135		83,135.00	
Capital items	12,561		12,561.00	
Transfers between accounts	--		21,600.00	
		471,061		492,661.14
Excess expenditures over funds		47,240		48,007.58
Net deposits of business receipts		384,029		386,013.01
Gross receipts—as determined		431,269		434,020.59
Gross receipts—reported		380,731		380,731.00
Gross receipts—unreported		50,538		53,289.59

Petitioner's first contention is that respondent overstates the amount of nondeductible expenditures and, thereby, erroneously increases the unreported income computed under the bank deposits method. Set out below is a schedule which shows the nondeductible expenditures determined by respondent in the notice of deficiency and the position of each of the parties regarding the nondeductible expenditures made by petitioner during 1982:

1982 Nondeductible Expenditures	Notice	Petitioner's Position	Respondent's Position
Personal living expenses:			
Per check spread	$43,135	--	--
Loan repayment on 5/21/82	20,000	$20,000	$20,000.00
Loan repayment on 4/08/82	20,000	20,000	20,000.00
Checks on Southwest acct. (Ex. 15)	--	12,811	12,811.00
Loan repayment on 3/30/82	--	--	4,000.00
Loan repayment on 3/30/82	--	--	10,000.00
Food allowance, $50 per week	--	2,600	--
Clothing allowance	--	1,170	--
Loans to others	--	272	3,072.00
Typewriter, calculator, etc.	--	443	--
Stock purchases	--	6,959	15,087.32
Personal portion of Sch. C expenses	--	7,332	8,984.59
Unexplained expenditures, Southwest acct.	--	--	20,766.71
Subtotal	83,135	71,587	114,721.62
Capital expenditures:			
Camaro automobile	11,318	--	11,318.00
Other capital items	1,242	1,242	1,242.00
Subtotal	12,560	1,242	12,560.00
Total	95,695	72,829	127,281.62

It is readily apparent from the above that petitioner concedes having spent $71,587 for personal living expenses and $1,242 to purchase certain capital assets. Thus, petitioner concedes having spent a total of $72,829 for personal living expenses and capital items; i.e., $22,866 less than the amount determined in the notice of deficiency, $95,695. It is also readily apparent from the above schedule that respondent contends that petitioner spent, at least, $114,721.62 for personal living expenses, and $12,560 for capital items. Thus, respondent contends that petitioner spent a total of $127,281.62; i.e., $31,586.62 more than the amount determined in the notice of deficiency.

We note that respondent has not sought to increase the deficiency for 1982 based upon the contention, summarized above, that a greater amount of nondeductible expenditures was proven at trial than was taken into account in the notice of deficiency. Accordingly, it is not necessary for us to resolve all of the factual differences between the parties regarding each of the nondeductible expenditures summarized in the above schedule. If we find that petitioner spent at least $95,695, the amount determined in the notice of deficiency, for personal living expenses and capital assets in 1982, then we must sustain respondent on this point.

In addition to the amount conceded by petitioner in his post-trial brief, $72,829, we find, as further discussed below, that petitioner made loan repayments of $4,000 and $10,000, and spent $11,318 to purchase a Camaro automobile. Thus, we find that petitioner spent at least $98,147 for personal living expenses and capital assets. Accordingly, petitioner has failed to prove that respondent overstated the nondeductible expenditures made by petitioner during 1982.

The loan repayments of $4,000 and $10,000 that are set forth in the above schedule are listed in petitioner's 1982 cash disbursements journal of checks written from petitioner's first Brentwood account, as follows:

Date	Check No.	Description	Amount
3/30	864	Tower Grove Bank loan $4,000 interest $51.60	$4,051.60
3/30	865	Badin Bank loan $10,000 interest $245.10	10,245.10

Petitioner admits that the loan repayments are among the personal expenses for 1982 established by the evidence presented at trial. Nevertheless, he contends that they cannot be taken into account in respondent's bank deposits analysis because respondent failed to include them among the personal living expenses determined in the notice of deficiency. According to petitioner, "no timely assessment of this alleged additional deficiency was made and same is therefore, barred by the Statute of Limitations."

In making this argument, petitioner fails to appreciate the fact that, as mentioned above, respondent is not asking the Court to redetermine a greater deficiency than that determined in the notice of deficiency. Petitioner also fails to appreciate the fact that once a notice of deficiency is issued, the running of the period of limitations on assessment is suspended during the period the Secretary is prohibited from assessing tax and, if a petition for redetermination is filed in this Court, the period is suspended until the decision of the Court becomes final, and for 60 days thereafter. Sec. 6503(a)(1). At this time, the period of limitations under section 6501(a) for assessing and collecting petitioner's 1982 income taxes is suspended. Therefore, even if respondent were seeking a greater deficiency, the period of limitations on assessment under section 6501(a) would not be a bar.

Petitioner raises no other objection to taking the subject loan repayments into account. In fact, petitioner concedes that the subject loan repayments of $4,000 and $10,000 are among the personal expenses established by the evidence presented at trial.

The issue here is whether petitioner has proven his contention that respondent's bank deposits plus cash expenditures analysis overstates the amount of his nondeductible expenditures in the form of personal living expenses and capital expenditures. Petitioner has advanced no reason why, in considering that issue, we cannot take into account the personal living expenses established at trial, including the subject loan repayment of $4,000 and $10,000.

In the case of the Camaro automobile, petitioner denies that he spent $11,318 to purchase a Camaro automobile at the end of 1982. He asserts that he acquired the automobile under a "36-month installment contract". However, petitioner's testimony on this point is vague and self-serving, and petitioner failed to produce the installment contract he claims to have entered into. In this situation, we infer that the contract governing his acquisition of the Camaro automobile would not be favorable to his position in these cases. *Wichita Terminal Elevator Co. v. Commissioner*, 6 T.C. 1158, 1165 (1946), affd. 162 F.2d 513 (10th Cir. 1947).

Petitioner's second contention is that respondent's recomputation of petitioner's income fails to take into account the fact that he had nontaxable funds of $46,646. Petitioner asserts that $30,000 of such amount came from loan proceeds, $10,000 of which was deposited into the first Brentwood account, and $20,000 of which was deposited into the Southwest account. Petitioner asserts that the remaining $16,646 consists of the combined opening balances of petitioner's bank accounts on January 1, 1982, $20,756.47, less the checks which had been written on those funds in 1981, but were still outstanding on January 1, 1982, $4,110.06.

As to the first point, petitioner is wrong in contending that respondent's determination does not take into account loan proceeds of $30,000. The "bank deposit method worksheet" for 1982 which is attached to the subject notice of deficiency shows, at "NOTE G", that petitioner's bank deposits were reduced by "loan proceeds deposited" in the amount of $30,000.

As to petitioner's second point, we agree that respondent's reconstruction, as set forth in the notice of deficiency, does not take into account the correct opening balances of petitioner's bank accounts less checks outstanding. The "bank deposit method worksheet" for 1982, which is attached to the notice of deficiency, shows opening balances of $2,259 and no checks outstanding, whereas the parties have stipulated that the aggregate balance in petitioner's accounts was $20,756.47, and the aggregate checks outstanding on January 1, 1982, was $4,110.06. We also agree that this error would tend to overstate the amount of unreported income. Nevertheless, when respondent's reconstruction of petitioner's income is revised to take into account all of the amounts stipulated by the parties, including the correct opening balance of petitioner's accounts and checks outstanding on January 1, 1982, the amount of omitted income computed thereunder is $53,289.59, that is, more than the amount determined in the notice of deficiency. That revised computation is summarized above. Thus, while we agree with petitioner that respondent's reconstruction is wrong on this point, petitioner has failed to prove that the error caused the omitted income determined by respondent to be overstated.

The third contention made by petitioner is that respondent's reconstruction fails to take into account "substantial non-taxable dollars to petitioner" from "an automobile accident and medical malpractice suit". Petitioner, of course, bears the burden of proving that he realized such nontaxable income. E.g., *Parks v. Commissioner*, 94 T.C. 654, 658-659 (1990); *Tokarski v. Commissioner*, 87 T.C. 74, 75-76 (1986); *Estate of Mason v. Commissioner*, 64 T.C. 651, 656-657 (1975), affd. 566 F.2d 2 (6th Cir. 1977).

Petitioner introduced no documents to substantiate that assertion. He relies entirely upon the following question and answer during his direct testimony at trial:

> Q Mr. Caulfield, with regard to that category, do you know of or do you believe that you had any other funds available to you during the tax year 1982, either from nontaxable sources or from business income?
>
> A Mr. Suddarth, that's really impossible to say. I have researched and looked through my records. I was involved in an automobile accident; I had a medical malpractice suit, Your Honor. Some time in the eighties, both of those litigations settled. But to the best of my knowledge and the best of my records that I've been able to reassemble, this is an accurate picture of my financial position for the year 1982.

The above testimony does not set forth the date or the amount of the recoveries which petitioner claims to have received. Accordingly, we find that petitioner has failed to establish that he realized additional nontaxable income during 1982, and we reject petitioner's contention that respondent erred by failing to take any such recoveries into account.

Taxable Year 1984

Respondent found that the expenditures made by petitioner during 1984 exceeded the funds which were available in petitioner's bank accounts by $55,783. Respondent added that excess to the net deposits that had been made during the year, $771,445, and determined that petitioner's gross business receipts amounted to $827,228, $66,979 more than the amount he reported, $760,249. The following is a summary of respondent's reconstruction of petitioner's income for 1984, as determined in the notice of deficiency, and as revised in accordance with the stipulations of the parties:

1984 Summary:	Notice of Deficiency		Revised	
Funds available in banks		$1,600,831		$1,459,986.37
Deductible expenditures	$763,523		$763,523.00	
Non-deductible expenditures:				
Personal living expenses	57,771		57,771.00	
Capital items	22,002		22,002.00	
Transfers between accounts	813,318		675,820.91	
		1,656,614		1,519,116.91
Excess expenditures over funds		55,783		59,130.54
Net deposits		771,445		780,188.55
Gross receipts—as determined		827,228		839,319.09
Gross receipts —reported		760,249		760,249.00
Gross receipts—unreported		66,979		79,070.09

Petitioner's first contention is that respondent overstated petitioner's personal living expenses for 1984, a component of nondeductible expenditures, and thereby overstated the amount of unreported income for the year. Set out below is a schedule which shows the personal living expenses determined by respondent in the notice of deficiency and the position of each of the parties regarding the personal living expenses paid by petitioner during 1984:

1984 Nondeductible Expenditures	Notice	Petitioner's Position	Respndents Position
Personal living expenses:			
Personal expenses	$47,170	--	--
Divorce settlement	10,601	$10,601	10,601.00
Checks on Southwest acct. (Ex. 17)	--	14,965	14,965.00
Food allowance	--	2,080	--
Clothes allowance	--	1,040	--
1984 depreciation schedule	--	4,197	--
Home alarm	--	1,990	1,990.00
Washer and dryer	--	1,148	1,148.00
Continental Ins.	--	1,227	1,673.45
Riding lawn mower	--	667	667.00
Misc. personal expenses	--	490	394.00
Personal portion of Sch. C expenses	--	2,873	2,890.00
Personal property	--	242	--
IRA	--	2,000	2,000.00
Travel, entertainment and boat	--	1,881	1,881.00
Springfield Associates	--	6,900	6,900.00
Unexplained expenditures, Southwest acct.	--	--	7,047.77
Weekly payments of $250, 49 weeks	--	--	12,250.00
Payment to Sears, 9/13	--	--	551.82
Checks to cash, 1/16 and 8/29	--	--	3,060.00
Total	57,771	52,301	68,019.04

It is readily apparent from the above that respondent determined in the notice of deficiency that petitioner had spent $57,771 for personal living expenses and petitioner concedes that he spent $52,301 for personal living expenses, $5,470 less than the amount set out in the notice of deficiency.

It is also apparent from the above schedule that respondent contends that petitioner actually spent, at least, $68,019.04 for personal expenses during 1984. However, respondent does not seek to increase the 1984 deficiency based upon the additional expenditures. Therefore, as was true for 1982, we need not resolve the disagreements between the parties concerning each of the additional expenditures asserted by respondent. We will sustain respondent's determination if the sum of the amounts conceded by petitioner, $52,301, plus other expenditures equals or exceeds the amount determined in the notice of deficiency, $57,771.

We note that one additional expenditure asserted by respondent, as shown in the above schedule, is labeled unexplained expenditures from petitioner's Southwest account in the amount of $7,047.77. This amount consists of the total expenditures from the Southwest account during 1984, $22,012.65 (beginning balance $1,298, plus deposits of $23,691, less ending balance of $2,976.35), less the expenditures from the account that petitioner concedes are personal expenses, $14,964.88.

At trial, petitioner introduced a schedule of checks written from the Southwest account totaling $14,964.88 which he testified were personal expenditures. On cross-examination, respondent's attorney asked petitioner whether the remaining expenditures from the Southwest account, $7,047.77, were personal expenditures. The question by respondent's attorney and petitioner's reply are as follows:

> Q Well, I'll try to ask the question a little more precisely this time. You have identified approximately $15,000

in personal expenditures from your Southwest Bank account. There were deposits including $9,200 in transfer -- there were total deposits of approximately $22,000. Would that remaining sum of approximately $7000 -- was that used for business or personal expenses?

A I don't know. The money was intermingled and used for both.

Respondent's post-trial brief sets forth the following proposed finding of fact:

> 48. During the taxable year 1984 petitioner expended $22,012.65 from his Southwest Federal Bank Account for personal purposes.

In his reply brief, petitioner entered no objection to the above proposed finding of fact. Accordingly, we find that all of the funds expended from petitioner's Southwest account during 1984, including the so-called unexplained expenditures from the Southwest account in the amount of $7,047.77, were personal expenditures.

The personal living expenses conceded by petitioner in his post-trial brief, $52,301, plus the additional personal living expenses paid from petitioner's Southwest account, $7,047.77, total more than the personal living expenditures determined in the notice of deficiency. Therefore, we find that petitioner has failed to prove that respondent's reconstruction of petitioner's 1984 income overstates the amount of personal living expenses.

Petitioner raises a second objection to respondent's reconstruction of his 1984 income. He contends that the reconstruction fails to take into account nontaxable income in the sum of $74,615. Petitioner's discussion of this point is not entirely clear, but it appears that he computes such amount as shown in the second column below:

Aggregate opening balance in bank accounts	$95,133	$84,241.00
Less: prior year's checks	32,489	46,296.37
Difference	62,644	37,944.63
Rounded to	60,000	
Plus: deposits to Southwest account	24,315	23,691.00
Less: transfers to Southwest account	9,700 74,615	9,200.00 52,435.63

The third column of the above schedule is the same computation using the amounts stipulated by the parties.

We have a number of difficulties with petitioner's contention that the above is a computation of nontaxable income which respondent's recomputation fails to take into consideration. First, we find no basis in the record of these cases for the contention, implicit in the above computation, that the net deposits to petitioner's Southwest account during 1984 consisted entirely of nontaxable income. Furthermore, contrary to petitioner's contention, all of the other amounts used in petitioner's computation are properly taken into account in respondent's reconstruction of petitioner's income for 1984 under the bank deposits plus cash expenditures method described above.

Self-Employment Taxes

Respondent determined that petitioner is liable for self-employment taxes under section 1401 for 1982 and 1984. Section 1401 imposes self-employment taxes on the "self-employment income" of every individual. Section 1402(b) defines "self-employment income" as the "net earnings from self-employment" derived by an individual during the taxable year with certain exceptions that are not relevant in these cases. The term

"net earnings from self-employment" is generally defined in section 1402(a) as the gross income derived by an individual from any "trade or business" carried on by such individual, less the deductions attributable to such trade or business.

Petitioner bears the burden of proving that he is not liable for the taxes imposed by section 1401 as determined by respondent. Rule 142(a). Petitioner introduced no evidence on this issue at trial, and he made no argument concerning self-employment taxes in his post-trial briefs. Accordingly, we sustain respondent's determination that petitioner is liable for self-employment taxes.

Negligence Additions Under Section 6653(a)

Respondent determined that petitioner is liable for additions to tax for negligence pursuant to section 6653(a)(1) and (2). Section 6653(a)(1) imposes an addition to tax equal to 5 percent of the underpayment, if any part of the underpayment for the year is due to a taxpayer's negligent or intentional disregard of respondent's rules or regulations. Section 6653(a)(2) imposes an addition to tax equal to 50 percent of the interest payable under section 6601 with respect to any portion of the underpayment which is attributable to the negligence or intentional disregard of the rules or regulations.

Petitioner bears the burden of proving that no part of the underpayment was due to his negligence or intentional disregard of respondent's rules and/or regulations. Rule. 142(a); *Axelrod v. Commissioner*, 56 T.C. 248, 258-259 (1971). Petitioner introduced no evidence on this issue at trial, but argues in his answering brief that there was no underpayment for 1982 and 1984 and, therefore, no addition to tax under section 6653. As discussed above, we sustain respondent's determination of an underpayment for 1982 and 1984. Accordingly, we also sustain respondent's determination of the additions to tax under section 6653(a)(1) and (2).

Addition to Tax Under Section 6661

Respondent determined that petitioner is liable for the addition to tax pursuant to section 6661(a) for 1984. Section 6661(a) imposes an addition to tax equal to 25 percent of any underpayment attributable to a "substantial understatement" of income tax for the taxable year. In the case of a noncorporate taxpayer, an understatement is substantial if it exceeds the greater of 10 percent of the tax required to be shown on the return, or $5,000. Sec. 6661(b)(1).

Petitioner bears the burden of proof on this issue. Rule 142(a). Petitioner presented no evidence on this issue at trial but argues in his answering brief "that since no understatement [sic] exist the penalty is inapplicable." As discussed above, we sustain respondent's determination of underpayments for 1982 and 1984 attributable to substantial understatements of income tax. Accordingly, we also sustain respondent's determination of the addition to tax under section 6661.

For the foregoing reasons,

Decisions will be entered for respondent.

APPENDIX B

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

Nos. 93-4054 and 93-4057

Joseph P. Caulfield,
Appellant,

v.

Commissioner of Internal Revenue,
Appellee.

Submitted: May 12, 1994
Filed: August 29, 1994

Before BEAM, Circuit Judge, HENLEY, Senior Circuit Judge, and LOKEN, Circuit Judge.

LOKEN, Circuit Judge.

Using the bank-deposits-plus-cash-expenditures method to reconstruct taxable income, the Commissioner of Internal Revenue determined that Joseph Caulfield, a public insurance adjuster, underpaid his 1982 and 1984 federal income taxes. The Commissioner assessed tax deficiencies for those years, including negligence and underpayment additions. The Tax Court upheld the Commissioner in all respects. *See Caulfield v. Commissioner*, 66 T.C.M. (CCH) 710 (1993). Caulfield challenges the reconstruction of his taxable income and the addition of negligence and underpayment penalties. We affirm.

Caulfield's business is conducted as a sole proprietorship. The Commissioner determined that Caulfield's cash-receipts-and-disbursements method of accounting did not clearly reflect his income in 1982 and 1984. That permitted her to determine Caulfield's income by "such method as, in the opinion of the

Secretary, does clearly reflect income." I.R.C. § 446(b).[1] The Commissioner chose the bank-deposits-plus-cash-expenditures method to recompute Caulfield's taxable income. *See generally United States v. Abodeely*, 801 F.2d 1020, 1023-24 (8th Cir. 1986); *Burke v. Commissioner*, 929 F.2d 110, 112 (2d Cir. 1991).

The Commissioner first calculated the net bank funds available to pay Caulfield's business expenses each year. She did this by subtracting nondeductible expenditures and bank account transfers from Caulfield's total bank account funds available in 1982 ($423,821 - $95,696 = $328,125), and 1984 ($1,600,831 - $893,091 = $707,740). The Commissioner then subtracted net bank funds available from the total cash business expenses Caulfield deducted on Schedule C of his Form 1040 returns ($375,365 in 1982 and $763,523 in 1984). The Commissioner treated the resulting amount as business expenses not paid with deposited funds. She added that amount ($47,240 for 1982 and $55,783 for 1984) to Caulfield's net business bank deposits to arrive at his gross business receipts, $431,269 in 1982 ($384,029 + $47,240), and $827,228 in 1984 ($771,445 + $55,783).

The Commissioner concluded that Caulfield understated taxable income on his returns by the difference between her calculation of gross business receipts and the amounts Caulfield reported ($431,269 - $380,731 = $50,538 for 1982; $827,228 - $760,249 = $66,979 for 1984). Based upon this understatement, the Commissioner determined that Caulfield had underpaid income tax by $21,974 in 1982 and $15,949 in 1984. She assessed the following deficiencies: for 1982, $21,974 plus negligence additions of $1,099 and fifty percent of the interest due on $21,974; for 1984, $15,949 plus negligence additions of $797 and fifty percent of the interest due on $15,949, plus a substantial understatement addition of $3,987.

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[1] Unless otherwise noted, all section references are to the Internal Revenue Code in effect for the years in issue.

The Tax Court meticulously reviewed, and found appropriate, the Commissioner's use of the bank-deposits-plus-cash-expenditures method. The Court considered and rejected the fact-intensive contentions Caulfield renews on appeal. The Court then restated the Commissioner's calculations, using figures derived from the Court's findings and the parties' stipulation of facts. Though the Court's calculation of total deposits, net business deposits, net funds available, business expenses paid with undeposited funds, and gross unreported income differed from the Commissioner's, it found that all discrepancies were to the taxpayer's advantage. Noting that the Commissioner did not seek an increased deficiency based on the stipulated numbers, and that "mathematical exactitude" is not required, the Court upheld the tax deficiencies of $21,974 in 1982 and $15,949 in 1984. It also upheld the assessment of negligence and substantial underpayment additions because Caulfield presented no evidence on these issues.

I. The Deficiencies in Tax.

A. On appeal, Caulfield first argues that the Commissioner erred in concluding that he did not keep adequate tax records. This contention is totally without merit. First, it was not properly preserved -- the Tax Court stated that Caulfield "does not challenge [the Commissioner's] finding of inadequate records or otherwise seriously question [her] authority to reconstruct his income." 66 T.C.M. at 715. Second, although Caulfield asserts that his cash-receipts-and-disbursements method was sound, and was in fact used by the Commissioner in reconstructing his income, the problem in this case was not what Caulfield's records showed, it was the substantial *unrecorded* taxable income. As the Third Circuit observed in rejecting a similar contention in *Schwarzkopf v. Commissioner*, 246 F.2d 731, 733-34 (3d Cir. 1957):

> If taxpayer's contention is correct, everyone could keep a set of apparently accurate books, carefully destroy other

evidences of the source and amount of income, and defend by an alien rule that the net worth method may not be used in those circumstances -- and thus the government could be defrauded with impunity.

B. A presumption of correctness normally attaches to the Commissioner's assessment of a tax deficiency. *See Welch v. Helvering*, 290 U.S. 111, 115 (1933). Caulfield next argues that the Commissioner's method of redetermining his taxable income is not entitled to that presumption because it was full of errors, and because she did not properly eliminate his alleged sources of non-taxable income, namely $32,588 withdrawn from a bank account in 1982, and undocumented settlements of automobile accident and medical malpractice lawsuits. We disagree.

"This court must accept the Commissioner's method of reconstructing income so long as it is rationally based." *Rowell v. Commissioner*, 884 F.2d 1085, 1087 (8th Cir. 1989). The bank-deposits-plus-cash-expenditures method is a rational way to reconstruct taxable income, *see Abodeely*, 801 F.2d at 1024-25; *Parks v. Commissioner*, 94 T.C. 654, 658 (1990), provided the Commissioner has properly segregated taxable and non-taxable income and expenditures, *compare Burke*, 929 F.2d at 112, *with Teichner v. Commissioner*, 453 F.2d 944, 945-47 (2d Cir. 1972). The Commissioner's assessment "is expected to be rational, not flawless." *Dodge v. Commissioner*, 981 F.2d 350, 353 (8th Cir. 1992), *cert. denied*, 114 S. Ct. 58 (1993).

The Tax Court rejected Caulfield's factual allegations of error, such as the assertion that an $11,318 Camaro was not a personal expenditure in 1982 because he bought it on credit.[2] *See*

[2] In his reply brief, Caulfield asserted that the "contract to purchase the Camaro" was discovered in the Commissioner's files after trial and urged us to remand for further proceedings in the Tax Court. At oral argument, however, he admitted that the new document reflects a bank loan, not an installment purchase, and he did not persuade us this is material, newly discovered evidence. We deny the request for remand.

66 T.C.M at 718. The Court properly accounted for opening and closing bank balances, *see* 66 T.C.M. at 713-14, and rejected Caulfield's claim of litigation settlement income as totally unsupported, *see* 66 T.C.M. at 719. The Court further found that any inaccuracies in the Commissioner's calculations were to Caulfield's advantage. These findings are not clearly erroneous. *See Moser v. Commissioner*, 914 F.2d 1040, 1044 (8th Cir. 1990) (standard of review). Therefore, we agree that the Commissioner's reconstruction of Caulfield's taxable income is entitled to the presumption of correctness. Taxpayers who cannot produce adequate records "may not complain of the inevitable inaccuracies in assessment their default occasions." *Dodge*, 981 F.2d at 353.

For the foregoing reasons, we affirm the Commissioner's calculation and assessment of tax deficiencies for 1982 and 1984.

II. The Additions to Tax.

A. Caulfield argues that he should not have been assessed negligence penalties under § 6653 (a)(1) and (2). Under these provisions (since repealed), "[i]f any part of any underpayment . . . of any tax . . . is due to negligence," the Commissioner adds penalties equal to five percent of the underpayment, § 6653(a)(1), and fifty percent of the interest on "the portion of the underpayment . . . attributable to the negligence," § 6653(a)(2). As the Tax Court noted, the taxpayer "bears the burden of proving that the Commissioner's assessment of a penalty for negligence was improper." *Edison Homes, Inc. v. Commissioner*, 903 F.2d 579, 584 (8th Cir.), *cert. denied*, 498 U.S. 984 (1990); *see Chase v. Commissioner*, 926 F.2d 737, 740 (8th Cir. 1991).

Caulfield presented no evidence on this issue other than to defend the accuracy of his tax returns. When a taxpayer fails to maintain adequate records of his taxable income, the Commissioner is put to the time-consuming task of reconstructing taxable income. If additional tax is then owing, it is particularly

appropriate that the taxpayer pay, as a penalty, significantly more than the interest that is otherwise owed for late payment of the tax, unless he can affirmatively demonstrate that the failure was not due to negligence. *See Catalano v. Commissioner*, 81 T.C. 8, 17 (1983); *Axelrod v. Commissioner*, 56 T.C. 248, 258-59 (1971). The Tax Court correctly upheld the negligence additions in this case.

B. Caulfield also challenges the substantial understatement addition to his 1984 tax.[3] Although § 6661(a) provides that a twenty-five percent penalty "shall be added," the taxpayer may avoid this addition in either of two ways -- by proving there is "substantial authority" for his position, *see* § 6661(b)(2)(B)(i); *Norgaard v. Commissioner*, 939 F.2d 874, 880-81 (9th Cir. 1991), or by persuading the Commissioner to waive the penalty, *see* § 6661(c); *Heasley v. Commissioner*, 902 F.2d 380, 385 (5th Cir. 1990). Courts review the Commissioner's decision not to waive the penalty for abuse of discretion. *See, e.g., Karr v. Commissioner*, 924 F.2d 1018, 1026 (11th Cir. 1991), *cert. denied*, 112 S. Ct. 992 (1992).

Caulfield did not prove substantial authority for his position, nor did he ask the Commissioner to waive the substantial understatement penalty. On appeal, he argues that the penalty is unfair because he reported his income in good faith and cooperated with the Commissioner's audit. But the principal purpose of this penalty is "to deter taxpayers from playing the 'audit lottery,' that is, taking undisclosed questionable reporting positions and gambling that they [will] not be audited." *Karpa v. Commissioner*, 909 F.2d 784, 786 (4th Cir. 1990). Thus,

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[3] A substantial understatement is one that exceeds the greater of 10% of the tax required to be shown on the return, or $5,000. *See* § 6661(b)(1). Congress raised the penalty from 10% to 25% in the Omnibus Budget Reconciliation Act of 1986, Pub. L. No. 99-509, § 8002, 100 Stat. at 1951. *See generally Pallottini v. Commissioner*, 90 T.C. 498, 500-03 (1988).

Caulfield's faulty record-keeping and substantial understatement fall squarely within the purview of the statute.

It is well established that the Commissioner may impose both negligence and substantial understatement additions. *See Dodge*, 981 F.2d at 357; *Cramer v. Commissioner*, 101 T.C. 225, 257-59 (1993). The Commissioner should exercise her discretion under § 6661(c) to avoid unwarranted duplication of penalties, since "[t]he I.R.S. should not exact every penalty possible in every case where taxpayers pay less than the full amount of tax due." *Heasley*, 902 F.2d at 386.[4] However, in this case, Caulfield's taxable income and tax were very substantially understated, his proper tax liability was camouflaged by inadequate records, and it appears the Commissioner exercised discretion by not imposing a substantial understatement penalty for 1982. Thus, there was no abuse of discretion in imposing that penalty for 1984.

We have carefully considered Caulfield's other contentions and conclude they are without merit. The judgment of the Tax Court is affirmed. Caulfield's motion to stay the judgment is denied. *See* I.R.C. § 7485.

A true copy.

Attest:

CLERK, U. S. COURT OF APPEALS,
EIGHTH CIRCUIT.

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[4]We note in this regard that Congress recently replaced both penalties with a single twenty percent addition. *See* the current § 6662; Omnibus Budget Reconciliation Act of 1989, Pub. L. 101-239, §§ 7701, 7721, 103 Stat. 2388, 2395 (1989).

APPENDIX C

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

No. 93-4054/93-4057

Joseph P. Caulfield,
Appellant,

v.

Commissioner of Internal Revenue,
Appellee.

Order Denying Petition for Rehearing and
Suggestion for Rehearing En Banc

The suggestion for rehearing en banc is denied. The petition for rehearing by the panel is also denied.

October 19, 1994

Order Entered at the Direction of the Court:
/s/ Michael E. Gans
Clerk, U.S. Court of Appeals, Eighth Circuit